



Testimony

Of

**Daniel M. Sibears
Senior Vice President and Deputy
Member Regulation**

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Introduction

On behalf of the National Association of Securities Dealers (“NASD”), I want to thank the Committee for this opportunity to testify. My name is Daniel M. Sibears and I am a Senior Vice President and Deputy for Member Regulation at NASD in Washington, D.C.

I am pleased to have the opportunity to appear before this special hearing to provide you with information about the regulation of the securities industry and the role of NASD in regulating broker dealers.

As the world’s largest securities self-regulatory organization (“SRO”), NASD has been helping to bring integrity to the markets for more than 60 years. Market integrity and investor protection are at the core of NASD’s mission and are the foundation of the success of U.S. financial markets.

Under federal law, virtually all securities firms doing business with the American public are members of the NASD, a private sector, not-for-profit SRO. Roughly 5,500 brokerage firms, and almost 700,000 registered securities representatives come under our jurisdiction.

NASD writes rules that govern the behavior of securities firms and their associated persons, examines firms for compliance with these rules, as well as the federal securities laws, the rules of the Securities and Exchange Commission (“SEC”) and the Municipal Securities Rulemaking Board, and disciplines securities firms and their employees if they fail to comply.

Our market integrity responsibilities include regulation, professional training, licensing and registration, investigation and enforcement, dispute resolution, and investor and member education. We monitor all trading on The Nasdaq Stock Market -- the largest-volume market in the world -- and in the over-the counter markets. We are staffed by 1600 professional regulators and governed by a Board of Governors -- at least half of whom are unaffiliated with the securities industry.

The co-existence of strong self-regulation and investor participation in the markets is no mere coincidence. Self-regulation brings to bear a keen practical understanding of the industry. It taps resources and perspectives not readily available to governments. It fosters investor protection and member involvement by promoting high standards that go beyond simply obeying the law. And it has helped to make the U.S. markets the most successful in the world.

Self-regulation works because the brokerage industry understands that market integrity leads to investor confidence, which is good for business. The overwhelming majority of NASD members comply with the letter and spirit of the rules and the law. They view their own reputation for fair dealing and high standards as an asset in a competitive industry.

NASD plays a crucial role in investor protection, which, in turn, is critical to investor confidence. By preventing problems before they happen, education may be the best form of investor protection. Our *Investor Alerts* give investors timely information that they need to spot problems before they happen. Through our Web site, publications, and investor outreach, we provide investors with information, tools, and resources they need to make effective use of the products and services that the securities industry offers. Our initiatives range from interactive programs that introduce children to the concept of saving to initiatives dealing with margin, online trading, and investing and retirement planning for adults.

NASD, other SROs and governmental regulators are not, however, the only level of regulation in the securities industry. Regulation starts with the securities firms themselves. All securities firms are subject to rules that require them to have supervisory systems and internal controls. The firms have personnel whose main responsibility is monitoring compliance with these rules, other SRO regulations and the federal securities laws. The scope and detail of these internal compliance departments varies given the substantial diversity of firms. Depending on the size of the firms and the type of business they do, they have to have effective mechanisms to monitor themselves for compliance with a myriad of regulations.

Effective supervisory systems form the foundation of a firm's ability to ensure that its associated persons are appropriately dealing with customers and that customers are protected. Appropriate supervision safeguards the firm and its customers and increases investor confidence, thereby, ultimately, ensuring the fair and efficient functioning of our markets.

Effective supervision is not static. Firms must continually evaluate the effectiveness of their policies, procedures, supervisory systems and internal controls and make appropriate changes when necessary. The systems need to be reviewed and revised to, among other things, reflect different risks and challenges that may be created in the market place, by hiring new personnel or when the firm's associated persons become, as I will describe below, the subject of one or more actions that raise the proverbial "red flag."

In addition, ordinary supervisory procedures may be insufficient to ensure compliance with federal securities laws and NASD or New York Stock Exchange (NYSE) rules and regulations in certain circumstances. In such circumstances, we look to the firms to impose heightened supervisory systems. Circumstances that may warrant heightened supervisory controls include registered representatives, whether new hires or current representatives, who have been the subject of numerous customer complaints, disciplinary actions or arbitrations; registered representatives terminated from association with prior firms for regulatory reasons or concerns; registered representatives who have frequently changed their employment; and registered representatives whose trading practices or customers appear on certain exception reports generated by the firm to monitor customer accounts.

In situations such as those I have mentioned, firms employing these brokers should take necessary, extra steps to establish heightened supervision. Firms should develop and employ special supervisory procedures tailored to the areas that were the subject of the broker's previous complaints, arbitrations, or disciplinary actions. In developing appropriate heightened supervisory procedures, the firm should analyze the product, customer, or activity type that was involved in the broker's prior misconduct or questionable behavior. The firm should then determine what type of supervision might best control and limit this risk to the customer and the firm. The procedures should also recognize the nature of the firm's business and the size and structure of the firm.

The supervisor who oversees the activities of the broker should be adequately qualified, appropriately trained, and have the necessary experience to carry out the heightened supervisory obligations. Individuals charged with carrying out heightened supervision, and the supervisory procedures put into place, must be able to detect signals that may indicate the broker is continuing to engage in further sales practice violations. Firms that ignore these signals or red flags of further sales practice violations, or that never put in place heightened supervision of problem brokers, may themselves be the subjects of disciplinary action for failure to supervise the brokers.

Several of our regulatory requirements are especially important as we learned in the wake of September 11th - such as anti-money laundering rules and requirements mandating that firms have business continuity plans in place. Firms must also ensure that their brokers are meeting continuing education requirements. In the area of compliance, the systems and controls that firms utilize can range from highly automated to manual and from internally managed to outsourced. Firms however, cannot contract away the responsibility and in the end must have strong systems designed to protect investors.

I recognize that the committee has a significant interest in the Gruttadauria case. Unfortunately I am not in a position to comment on that matter, which is currently under investigation by the NYSE . With respect to a few specific areas, such as financial/operational and options compliance, SROs divide responsibility as the Designated Examining Authority (DEA). For example, the NYSE assumes DEA responsibility for financial/operational inspections for firms that are dual NASD/NYSE members. As soon as this matter came to light, Lehman Brothers notified both the NASD (through our Cleveland office) and the NYSE . Because the matter appeared to involve internal financial control issues, and the NYSE is the designated examining authority for that firm, the matter was deferred to the NYSE for investigation.

Member Regulation

From its headquarters in Washington, DC, and through each of its 15 District Office locations, the Department of Member Regulation conducts a variety of programs to fulfill NASD's self-regulatory functions. These programs include our national examination program, the membership application process, a statutory disqualification program and our preventive compliance program.

The examination program is the largest function carried out by Member Regulation. On an annual basis, we examine approximately 2,600 brokerage firms' headquarters and over 200 branch offices. The yearly schedule of exams is prepared in conjunction with other SROs pursuant to an agreement that fosters cooperation among regulators and minimizes duplication.

The amount of time and scope of routine exams vary greatly. Large, full-service firms generally consume the greatest amount of time (including many weeks on-site) because of the size and complexity of their operations. Exams for very small firms, especially those with limited product lines or a small number of customer accounts, are generally completed with examiners spending just a few days on the premises.

The scope of our exams is determined by a risk-based focusing mechanism in which our regulatory intelligence and other data is analyzed. This risk-based approach allows us to devote our examination resources to areas that constitute the greatest risk to investors. Therefore, all aspects of a firm's business or operations are not necessarily subject to detailed inspection during every exam.

We are in the midst of deploying a completely new regulatory model that will technologically enable the examination program and permit us to conduct ongoing surveillance of firms for indications of serious potential problems in need of immediate attention. With INSITE -- which stands for Integrated National Surveillance and Information Technology Enhancements -- we use sophisticated data mining techniques to detect signals of change in member firm activities. This includes statistical analysis of customer complaints, transactional and trading information, registration information, and financial information.

Importantly, when we detect abusive practices occurring in the industry, we take immediate steps to apprise our members of the problem. For example, when we became aware of a number of scams that were being carried out through the use of bogus addresses or Post Office boxes for customer accounts, we issued a Member Alert highlighting the concern for our member firms and described seven specific approaches for firms to guard against their customers becoming the victim of a scam using this method of operation. In another instance, when we saw a prevalence of member firms experiencing losses when they accepted third party checks that were lost or stolen, we moved quickly and issued a Member Alert to inform all our member firms of the scams, how they worked and how they could protect themselves from suffering similar losses.

In addition to alerting our membership of the problem, we immediately reassessed our examination procedures to incorporate appropriate information to assist our examiners in reviewing for these practices. Regarding the use of bogus addresses and PO boxes to carry out investment scams, we revised our examination procedures so that our reviews will better detect potential fraudulent activities by brokers relative to: transfers of securities accounts; use of Post Office boxes; letters of authority to transfer accounts; and customers and brokers having the same mailing address. Ultimately, it is the firm's own

supervisory system and internal controls that, if appropriately designed, will likely detect and prevent this fraudulent activity. To that end, our examinations also may review the firm's supervisory system and internal controls relative to the firm processes I just described. Revising our examination procedures to capture new abusive practices that we encounter allows us to determine if our firms are meeting their regulatory obligations to have procedures that reasonably protect against the abusive practices being perpetrated against their customers.

Routine examinations seek to determine whether a firm is complying with Federal securities laws, rules, and regulations, and with NASD rules. Examinations begin with a detailed review of data that is available through NASD systems, such as securities industry registrations, firm financial data, and firm trading data.

Unless there is a regulatory reason for the examination to be unannounced, the examination staff contacts the firm in advance to request that the firm have specific records, based on the focus and scope of the examination, ready on the date specified. Most firm-wide examinations are conducted at the main office of the firm, although we have increasingly focused on examinations of branch office activities.

During the time at the firm's office, the examiners review the firm's books and records, such as financial computation workpapers and subsidiary ledgers, order tickets and confirmations, complaint and correspondence files, and many other such records. This review is leveraged by a recently released application that integrates questions, review steps, rule references, sampling schedules, and supporting information for examiner reference. Examiners check that the firm's records support the regulatory filings that the firm has made to the NASD in the case of trade reporting, financial filings, complaint filings, and advertising filings, for instance. Examiners prepare independent financial calculations to determine the financial condition of the firm (net capital and customer reserve). Most rules do not have regulatory reporting requirements, so the examiners use the firm's source records to ensure that applicable rules are being complied with; for example, that the firm's written supervisory procedures cover the business activities of the firm. Examiners also interview the firm's compliance officers and management to learn about its supervision and operational practices.

Upon completion of the fieldwork, examiners provide a summary of the initial findings of the examination, and the firm is asked to provide any additional information that should be considered in bringing resolution to the apparent violations noted. Examiners then write a report of the examination, including any apparent violations discovered, and provide it to NASD district office management for review. All apparent violations are supported by appropriate documentary evidence, which is made part of the examination file. Resolution of examinations can vary from an informal cautionary letter for minor deficiencies to referrals to the NASD Enforcement Department for further investigation of more serious violations. The Enforcement Department is authorized to initiate formal disciplinary action against members and their associated persons and to obtain sanctions including censures, fines, suspensions and even expulsions and permanent bars from the securities industry.

In addition to our routine exam program, we conduct approximately 15,000 "cause examinations" each year. Cause examinations generally are investigations of customer complaints (6,630 received in 2001) or cases in which brokers are terminated for cause. In 2001, we investigated approximately 5,504 terminations for cause and approximately 2,752 other matters that came to our attention.

These cause examinations are often conducted by telephone, e-mail, and mail. The examiners obtain an understanding of the problematic activity from the complaining customer or terminating firm. They then contact the appropriate broker or firm for their explanation of the facts surrounding the allegation. The examiner also requests all documentation necessary from the parties to verify the explanations of both sides.

NASD operates in cooperation with federal, state and other SROs to maximize its effectiveness and to fulfill its mission of ensuring market integrity and investor protection. Our in-house disciplinary efforts are supplemented by referrals to the SEC and, where appropriate, to federal and local criminal authorities.

In addition to the examination programs, Member Regulation also administers the NASD membership application process. In order to become an NASD member, a firm must complete a detailed application and demonstrate that it satisfies the criteria established for membership and the conduct of business. These criteria are designed to ensure that members are able to conduct business consistent with the requirements of the federal securities laws and in a manner that assures investor protection. NASD reviews approximately 400 applications for new membership annually. Firms are also required to submit information and seek approval for material changes to their business as well as ownership changes. Approximately 1,000 such applications are considered each year.

Finally, Member Regulation sponsors a variety of programs to assist member firms and their personnel in efforts to comply with the securities laws. Through seminars, publications, and our extensive web site (www.nasdr.com), NASD strives to provide timely guidance and information to help members keep abreast of new and changing regulatory obligations, assist firms in their self-policing efforts, and identify industry "best practices," all in an effort to facilitate investor protection. NASD and its District Offices hold approximately 100 outreach sessions annually.

In closing, I would be pleased to respond to any questions you may have or to address any specific areas in greater detail. Again, thank you for the opportunity to appear before you today.